

MAYER • BROWN

Navigating the Recession: What Companies Need to Consider Today

Saving Money in Outsourcing Contracts

Brad L. Peterson

Partner

+1 312 701 8568

bpeterson@mayerbrown.com

Paul J. N. Roy

Partner

+1 312 701 7370

proy@mayerbrown.com

January 13, 2009

Mayer Brown is a global legal services organization comprising legal practices that are separate entities ("Mayer Brown Practices"). The Mayer Brown Practices are: Mayer Brown LLP, a limited liability partnership established in the United States; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales; and JSM, a Hong Kong partnership, and its associated entities in Asia. The Mayer Brown Practices are known as Mayer Brown JSM in Asia.

Saving Money on Sourcing Contracts

- Existing Contracts
 - Verify invoicing and performance
 - Use contract rights and collaborate with Suppliers to cost-optimize scope, service levels and risk allocation
- New Contracts
 - Use cost-focused sourcing methods
 - Use multi-supplier sourcing

Cost-saving questions for lawyers to ask (and help to answer) on existing contracts

- Are you getting what you were promised?
- Are you paying only what you agreed to pay?
- Do you have a contractual right to cost-saving changes?
- Do you have the opportunity to reduce cost through mutually-advantageous trades?

Are you getting what you were promised?

- Why?
 - Cost-pressured suppliers may cut back on delivery
 - Customer teams may not be aware of all requirements
- Inventory contractual commitments, for example:
 - Staffing levels
 - Cost-savings commitments
 - Technology evolution
 - Deliverable requirements
 - Service level quality
 - In-scope project performance
- Verify performance against those commitments

Are you paying only what you agreed to pay?

- Suppliers may invoice based on incorrect data or an incorrect understanding of the pricing schedule
- Some credits and setoffs may not appear in the pricing schedule
- Audit provisions of contracts permit the customer to conduct financial audits to verify compliance with the contract
- Audits may also help customer identify cost-savings opportunities

Do you have a contractual right to cost-saving changes?

- General supplier obligation to minimize costs and achieve cost savings
- Obligation to make cost-saving proposals upon request
- “Extraordinary event” provisions
- Benchmarking rights
- Right to change rights and obligations

Right to change rights and obligations: Common examples

- Application rationalization to reduce portfolio
- Reduce required volumes (*e.g.*, impose email storage limitations)
- Relax response time requirements
- Lengthen hardware and software refresh rates
- Consolidate service delivery locations
- Authorize fewer projects

Right to change rights and obligations: In-sourcing, re-sourcing and termination

- Financial analysis may indicate that some contracts are not cost effective
- Outsourcing contracts generally restrict or impose cost upon in-sourcing, re-sourcing and termination, but:
 - Exceptions are often in rarely-visited sections of the contract
 - Opportunities may arise from changes in circumstances (e.g., Satyam)
 - The cost of performance problems may dwarf contract charges

Do you have the opportunity to reduce cost through mutually-advantageous trades?

- Suppliers may offer changes with higher value than those that you can mandate
 - Suppliers are getting cost-reduction requests from most customers, so they are developing ideas
 - Suppliers understand underlying costs and can propose ideas that customers would not identify
- Contract review can help identify opportunities for mutually-advantageous trades

Opportunity for mutually-advantageous trade: *Reduce Supplier's obligations*

- Protections that were cost-effective at contracting may be less necessary in later years. Examples:
 - Service description, including dragnet clauses
 - Service level requirements and credits
 - Custom requirements, especially local variations
 - Reporting requirements
 - Warranties and indemnities
 - Limits on supplier's right to use or own developed IP
 - Controls on supplier's staffing
 - Open-ended supplier obligations

Opportunity for mutually-advantageous trade: *Allow more work to go offshore*

- Customers may be more comfortable now with offshore
 - Supplier's capabilities may have improved
 - Your experience with offshore services has grown
- Evaluate associated risks for particular functions
 - Protection of IP rights may require pre-emptive steps
 - Higher levels of data security may be required
 - Import/export restrictions
 - Currency and inflation exposure
 - Due diligence on offshore locations

Opportunity for mutually-advantageous trade: *Take on more risks and responsibilities*

- Take on more risks, such as:
 - Currency risks
 - Risk of price changes in supplier costs
 - Risk of events out of either party's control
- Take on more responsibilities
 - Provide space, equipment and other resources
 - Provide additional information
 - Commit to “operational service levels” on customer responsibilities

Opportunity for mutually-advantageous trade: *Implement gain-sharing*

- Gain-sharing aligns incentives for cost savings
- Gain-sharing is more valuable in a credit crunch because it funds investment with future savings (instead of present borrowing)
- Don't limit sharing to savings for in-scope services
- Draft gain-sharing clauses carefully to avoid:
 - Overlap with Supplier's existing in-scope commitments for achieving cost savings
 - Savings that would have occurred without Supplier's investment

Opportunity for mutually-advantageous trade: *Expand contract scope or extend term*

- Supplier may reduce average rates if its total profit increases
- Supplier may reduce its average cost (and thus be willing to reduce its rates) based on:
 - Greater leverage of existing dedicated resources
 - Amortizing one-time costs over more years
 - Increased revenue on existing contract
- Customer may increase savings by saving over a larger scope or more years

Opportunity for mutually-advantageous trade: *Contract for a range of service options*

- In better times, many of our clients contracted for uniformly high service quality
- At this point, lower service levels may be more cost-effective for some parts of your business
- The supplier may be able to vary the service by function, country, region or even user (e.g., gold, silver or bronze service levels)
- The pricing mechanism can reward those who accept a lower standard of service while maintaining supplier profit

Opportunity for mutually-advantageous trade: *Renegotiate timing of charges or payment*

- The optimal timing of charges depends on each party's time-value-of-money calculation
- The credit crisis has dramatically changed the cost of capital, particularly for debt-funded companies. Opportunities may exist in:
 - Changing payment schedules to pay faster or slower
 - Pre-paying or amortizing costs for equipment, transition and transformation
 - Changing prices in current year and out-years

Ways to Save Money on New Outsourcing Arrangements

- Consider outsourcing new functions -- Supplier capabilities are growing and market is competitive
- Consider new approaches for outsourcing that can permit fast execution, flexibility, lower risk and best pricing over time.
 - Cost-focused outsourcing
 - Multi-sourcing

Implement cost-focused outsourcing

1. Preparation

- Form a cross-functional team with strong financial analysis skills
- Verify minimum requirements (e.g., to meet your compliance obligations)
- Gain internal alignment on what to sacrifice to obtain cost savings
- Obtain executive mandates necessary to overcome internal resistance

Implement cost-focused outsourcing

2. Implementation

- Make your cost-saving goal absolutely clear
- Specify only what's important; leave the bidders flexibility to design low-cost solutions
- Offer to reduce supplier risk, etc., as described earlier
- Seek creative ideas from suppliers
- Focus negotiation energy on points that drive cost savings
- Invest in tight contract language, particularly around what you're buying and how you're paying for it
 - Expect intense pressure on that language

Use multi-supplier sourcing

Goals

- Large scope awarded to multiple suppliers
 - Split awards
 - Best-of-breed sourcing
- Integrated governance
- Common contractual framework
- Incentives and commitments for cooperation among the collaborating competitors

Using multi-supplier sourcing: *Preparation*

- Create an enterprise-level negotiation team
- Share knowledge across the enterprise
- Leverage most mature sourcing processes and most experienced sourcing teams
- Develop contract templates suitable to manage collaborating competitors
- Identify portfolio of suppliers able to handle multiple functions

Using multi-supplier sourcing: *Advantages*

- Allows customer to move work to supplier with best price-performance
- Reduces overall risk through diversification
- Reduces negotiation time / accelerates benefits

Outsourcing: Ways to Cut Costs in Troubled Times

- Cutting costs in outsourcing requires deliberate and focused efforts but can pay substantial dividends
- While some cost savings strategies are clearly only for the customer's benefit, in many cases suppliers can be a valuable partner in helping the customer identify cost-savings alternatives